Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 94-88

In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	
Protection and Competition	)	MM Docket No. 92-266
Act of 1992: Rate Regulation	)	

SECOND ORDER ON RECONSIDERATION,
FOURTH REPORT AND ORDER,
AND FIFTH NOTICE OF PROPOSED RULEMAKING

Adopted: February 22, 1994 ; Released: March 30, 1994

By the Commission: **Commissioner Barrett issuing a statement.**

Comment Date: June 29, 1994
Reply Comment Date: July 29, 1994

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I. Introduction

1. In the April 1993 Report and Order and Further Notice of Proposed Rule Making ("the Rate Order") in this docket,[1] the Commission adopted cable rate regulation rules and policies pursuant to the Cable Television Consumer Protection and Competition Act of 1992.[2] In the Rate Order, we adopted a "benchmark" approach for setting initial rates for regulated cable service. Under the benchmark approach, regulated cable systems were required to use a formula established in the Rate Order to calculate an applicable benchmark -- an estimate of the rate that a cable system subject to effective competition with similar characteristics would charge.[3] Rates of cable systems at or below the benchmark were presumed to be reasonable; rates above the benchmark were presumed to be unreasonable. Cable systems whose rates exceeded the applicable benchmark were required to reduce their rates either to the benchmark or by ten percent, whichever reduction was less.[4] This ten percent

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[1] Report and Order and Further Notice of Proposed Rulemaking ("Rate Order"), MM Docket No. 92-266, FCC 93-177, 8 FCC Rcd 5631 (1993).

[2] Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992), 47 U.S.C. Section 534 (1992)(hereinafter "the 1992 Cable Act" or "the Cable Act of 1992"). The Cable Act of 1992 amends Title 6 of the Communications Act of 1934, as amended, 47 U.S.C. Section 521 et seq. (hereinafter "the Communications Act"). Our regulations implement Sections 3, 9, and 14 of the Cable Act of 1992.

[3] In the First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-428 (released Aug. 27, 1993), 9 FCC Rcd 1164 (1993), 58 FR 46718 (Sept. 2, 1993) ("First Recon. Order" or "Second R&O" or "Third Further NPRM"), we affirmed our decision to use a benchmark approach based on rates charged by systems subject to effective competition as the primary method for determining the reasonableness of regulated cable rates. We, however, left a number of issues to be decided in subsequent orders on reconsideration. This Order, and our Third Order on Reconsideration (released today) resolve pending petitions for reconsideration of the Rate Order, with the exception of leased access issues, which will be considered in a future order. See Rate Order at paras. 485-541.

[4] The requirement of a ten percent rate reduction, applied to a per-channel rate, was derived from aggregate programming service and equipment charges under a methodology prescribed by

"competitive differential" represented the average difference that the Commission determined existed between the rates of competitive and non-competitive cable systems.

2. In this decision, we amend our cable rate regulations to ensure both that the rates consumers pay for regulated cable services are reasonable and that our rules continue to promote economic growth in the cable industry. Using a revised economic model, we have recalculated the competitive differential and have concluded that the 17 percent differential determined by the revised model more accurately estimates the difference between effectively competitive and noncompetitive cable rates than the ten percent differential established in the Rate Order.

3. In addition, we have reconsidered our benchmark approach. As the record stands, we believe that all regulated cable systems should be required to establish rates based on the revised competitive differential unless they justify other rates through a cost-of-service showing. We conclude that this result is warranted for several reasons, including the language of the statute, economic theory, and the legislative history of the 1992 Cable Act establishing that cable systems generally have had an opportunity to exercise market power.[5] Furthermore, the Commission's data continues to demonstrate that rates charged by systems that are not subject to effective competition, as defined in the statute, are generally higher than rates charged by systems facing effective competition. We believe, therefore, that our revised competitive differential best estimates the extent to which noncompetitive systems have been charging unreasonable rates.

4. We are, however, establishing special transition rules that provide that noncompetitive cable systems charging relatively low prices (as measured by a revised benchmark that incorporates the 17 percent competitive differential) will not have to reduce their rates by the full competitive differential until the Commission has collected and analyzed data about such operators' prices and costs, and determined whether such a reduction is inappropriate. We anticipate that some data relevant to this issue will be collected as part of an industry cost study to be conducted by the Commission, while other data will be submitted by affected cable systems. At the conclusion of this process, the regulated rates of such systems will be set to reflect the full 17 percent differential if our analysis does

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the Commission.

[5] See H.R. Conf. Rep. No. 862, 102d Cong., 2d Sess. 2 (1992) (hereinafter "Conference Report"); Cable Act of 1992, Section 2(a)(2); see also infra paras. 43-46.

not show that the resulting rates would be unreasonably low -- that is, the rates would be lower than they would be if set by competitive pressures as determined by cost comparisons between noncompetitive systems and systems subject to effective competition.

5. We are following a similar approach with respect to cable systems owned by small cable operators, defined as cable companies that serve a total subscriber base of 15,000 or fewer. We will not require small operators to apply the new competitive differential until the Commission has collected and analyzed data about such operators' prices and costs. As with systems that charge relatively low prices, we anticipate that some data relevant to this issue will be collected as part of an industry cost study to be conducted by the Commission, while other data will be submitted by affected cable systems. At the conclusion of our analysis, small operators will have to apply the full competitive differential in the absence of evidence showing that its application would set their rates at unreasonable levels based on any unique costs that are systematically experienced by small operators, as well as differences demonstrated between noncompetitive and competitive small operators.

6. In addition, we adopt a Fourth Report and Order establishing a "going-forward" mechanism to govern future rate adjustments resulting from channel additions or deletions, or system upgrades. We also issue a Fifth Notice of Proposed Rulemaking to seek comment on whether and how our benchmark methodology should apply to systems with more than 100 channels. In addition, we seek comment on whether the going-forward rules adopted in this Order should be modified for systems with more than 100 channels and, more generally, whether our going-forward methodology should be modified to provide greater or lesser compensation to operators when channels are added or deleted from regulated tiers. We also seek comment on whether we should allow cable operators to charge higher rates for cable service provided to commercial establishments than to residential households. Finally, we seek comment on whether we should adopt further requirements to govern systems' move from transition relief to full reduction rates.

7. Simultaneously, we are issuing two related orders. One order resolves a variety of cable rate regulation issues that do not relate to rate calculations.[6] The other order establishes interim rules governing the "cost-of-service" procedures that cable operators may invoke if they believe that their costs of

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[6] Third Order on Reconsideration in Cable Rate Regulation and Tier Buy-Through Proceedings, MM Docket 92-266 and 92-262, FCC 94-40 (adopted Feb 22, 1994).

providing regulated cable service will support rates that are higher than those produced by the revised benchmark approach adopted in this Order.[7]

8. As a result of these revised rules, most regulated cable operators will have to apply the revised competitive differential by May 15, 1994, or, pursuant to some conditions, by July 14, 1994. A limited number of operators will be eligible for special transition treatment pursuant to which they will make smaller or no, rate reductions pending completion of price/cost studies by the Commission.[8] Cable systems that are eligible for transition treatment will be subject to the full 17 percent reduction later, unless our price/cost analysis reveals that its application to these systems is inappropriate.

II. Second Order on Reconsideration

A. Executive Summary

9. After Congress deregulated most cable rates in 1984,[9] the rates for many subscribers rose substantially.[10] Congress proceeded to study the cable industry, and found that "most cable television subscribers have no opportunity to select between competing cable systems." The result, it determined, "is undue market power for the cable operator as compared to that of consumers."[11] This conclusion is supported by the findings of numerous economists.[12]

10. In the 1992 Cable Act, Congress determined that the

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[7] See Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215, FCC 94-39 (adopted Feb. 22, 1994) ("Cost Proceeding").

[8] Operators that elect to establish rates based on cost-of-service are also not required to reduce rates by the competitive differential, subject to refund liability. See id.

[9] Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (1984).

[10] See U.S. General Accounting Office, Telecommunications: 1991 Survey of Cable Television Rates and Services, Report to the Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representatives (July, 1991) (hereinafter "GAO Report").

[11] Conference Report at 2.

[12] See infra para. 44 and note 60.

rates charged by cable systems that face head-to-head competition should not be regulated. Congress further decided that cable systems operated by municipalities and cable systems with low penetration should be deemed, as a matter of law, to be subject to "effective competition," and hence not subject to rate regulation.[13] But Congress provided that the rates charged by all other cable systems for basic tier service and upper program (i.e., cable service) tiers should be subject to regulation.[14]

11. The 1992 Cable Act directs the Commission to adopt regulations to ensure that rates for the basic service tier are "reasonable."[15] Congress made clear that the basic tier regulations must "be designed to achieve the goal of protecting subscribers" from paying rates that are higher than those that would be charged if their cable operator faced "effective competition."[16] Congress also required the Commission to "take into account" seven different factors, most of which relate to the costs of providing, and the revenues derived from, basic service.[17] While providing that basic tier rates must be "reasonable," establishing "the goal of protecting consumers," and directing the Commission to "take into account" seven different factors, Congress did not require the Commission to follow a specific methodology in setting rates. Indeed, the Conference Committee deleted a provision requiring a formulaic approach, and explained that it was giving "the Commission the authority to choose the best method of ensuring reasonable rates for the basic service tier."[18] Congress followed a similar approach with respect to regulated upper tier service.[19]

12. In April 1993, the Commission adopted cable rate regulations to implement these statutory provisions. At that time, we determined that the best approach for meeting our

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[13] Communications Act, Section 623(l)(1), 47 U.S.C. Section 543 (l)(1).

[14] Id. at Sections 623(a)(2)(A),(B), 47 U.S.C. Sections 543(a)(2)(A),(B).

[15] Id. at Section 623(b)(1), 47 U.S.C. Section 543(b)(1).

[16] Id.

[17] Communications Act, Section 623(b)(2)(C), 47 U.S.C. Section 543(b)(2)(C).

[18] Conference Report at 62.

[19] See Communications Act, Section 623(c), 47 U.S.C. Section 543(c); Conference Report at 64-65.

Congressional mandate was to rely principally on a benchmark methodology that requires noncompetitive systems to set rates at levels that approximate competitive prices.[20] That conclusion was derived both from the language of the statute mandating reasonable rates and from economic theory, which states that prices charged in a competitive marketplace are reasonable for operators and subscribers alike.[21] Competitive prices accurately reflect the true economic costs of the services provided.[22] Such prices, thus, provide market signals to guide consumer purchasing decisions and producer investment choices at levels that lead to the greatest net benefit from the consumption of those services.

13. In April 1993, we further concluded that the benchmark methodology should be coupled with a cost-of-service process to permit operators to prove, on a case-by-case basis, that their costs support rates higher than those produced by the benchmark calculations.[23] In addition, we adopted a "price cap" mechanism to ensure that future adjustments to initial rates set pursuant to the benchmark will be reasonable for both operators and subscribers.[24] We also announced that we would (1) examine systems with rates substantially above competitive levels to determine whether their rates were justified by higher costs, and (2) seek to refine our analyses through further industry surveys.[25] This comprehensive regulatory plan, we decided, addressed all of the various statutory factors and ensured that rates for all regulated service tiers will be reasonable, as required by the Act.[26]

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[20] Rate Order at paras. 205-207.

[21] See Communications Act, Section 623(b)(1), 47 U.S.C. Section 543(b)(1); see also F. Scherer and D. Ross, Industrial Market Structure and Economic Performance (3d. ed. 1990) at 20 (competitive markets result in the lowest prices for consumers consistent with a return sufficient to maintain investment needed to produce the industry's output efficiently).

[22] Scherer and Ross at 20.

[23] Rate Order at para. 15.

[24] Id.

[25] Id.

[26] See id. at paras. 15, 179-180. In our First Recon. Order in this proceeding, we, inter alia, affirmed our decision to use a benchmark system based on rates charged by systems subject to effective competition as the primary method of assessing the reasonableness of regulated cable rates. First Recon. Order at

14. The petitions for reconsideration filed in this proceeding have given us an opportunity to undertake a comprehensive review of our rate regulation scheme. The evidence and analysis now before us support our earlier conclusion that the benchmark methodology, coupled with a cost-of-service process, is an appropriate means of setting initial regulated cable rates. At the same time, the record and further analysis also persuade us that we should modify our methodology so as best to set "reasonable" rates for cable systems that are not subject to effective competition, as defined in the statute. Accordingly, we adopt several important modifications to our current rate regulation approach.

15. In implementing the congressional directives on reconsideration, we are guided principally by economic theory, which states that a cable system that is not subject to competition generally will have an opportunity to charge a higher than competitive rate for its package of program services and equipment. As a result, in our view, a noncompetitive rate is not a "reasonable" rate. Rather, "reasonable" rates are lower than noncompetitive rates, and should reflect a price similar to that charged by a system that faces competition.

16. Moreover, upon further reflection, we find no conclusive basis in economic theory or the record to assume that a cable operator that is subject to little or no competition, and whose rates, nonetheless, appear to be low (i.e., at or below a benchmark), is not exercising market power. Market power is reflected in the gap between price and cost. Without more detailed information on cost and demand conditions, it is impossible to determine the amount by which an operator's revenues exceed its costs. An operator's rates may be relatively low on account of the cost or demand conditions it faces, rather than because the operator is not exercising market power. Our analysis indicates that behavior reflective of market power may exist generally within the noncompetitive sector of the cable industry. In this Order on Reconsideration, we calculate a new "competitive differential" -- our best estimate of the average amount by which the rates charged by a cable operator not facing effective competition exceeds "reasonable" rates -- and conclude that it should apply to all regulated cable systems.

17. However, because we do not have sufficient cost data at this time, we are establishing transition rules for some cable operators. First, operators with relatively low prices (as measured by their position vis-a-vis the revised benchmark) will not be required immediately to reduce rates by the new competitive differential. The full reduction for these operators will be deferred until the Commission has collected and analyzed

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para. 13.

data about such operators' prices and determined whether the full reduction is inappropriate. As indicated, some data on costs and prices will be collected as part of an industry cost study to be conducted by the Commission. Cable operators and other interested parties will be given the opportunity to present information on costs and prices to help provide a complete record. This will give cable operators the opportunity to submit evidence showing that cable systems charging rates at or below the new benchmark are not exercising market power and, therefore, might warrant an application of less than the full revised competitive differential.

18. Second, we will not require cable systems owned by small operators to apply the competitive differential immediately. We recognize that some small systems may face higher than average costs. We also recognize that small operators may not have the financial resources to sustain the impact of a significant rate reduction. Our cost study thus will also permit small operators to present evidence showing whether, or to what extent, our revised competitive differential should be applied to them due to (1) the presence of unique costs, as identified in the record, that are systematically experienced by small operators, and (2) any differences that may be demonstrated between noncompetitive and competitive small operators. We note, however, that the existing record does not enable us to find that small operators and relatively low priced operators should not eventually be required to apply the full competitive differential. They therefore will be required to apply the full differential unless our analysis of the price/cost data we collect persuades us that a smaller competitive differential should be applied to them.

19. As noted, we also adjust the competitive differential in this Order. We previously calculated the competitive differential as approximately ten percent.[27] We made that calculation by analyzing data drawn from a sample of cable systems that included regulated systems and each of the three types of systems that Congress has exempted from rate regulation -- systems that have penetration rates less than 30 percent ("low penetration systems"), systems that face actual competition ("overbuilds"), and systems that are operated by municipalities ("municipals").[28] Our previous approach simply averaged the data from all systems subject to effective competition. On reconsideration, we have more closely analyzed the data from all three types of systems, and have used a qualitative, rather than

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[27] Rate Order at para. 180.

[28] See Communications Act, Section 623(e)(1), 47 U.S.C. Section 543(e)(1).

arithmetic, analysis to determine the differential whose application best approximates the "reasonable" rate that would be charged by a system that faces effective competition. Our revised competitive differential of 17 percent also reflects our analysis of the various factors that Congress has instructed us to take into account.

20. Our refined approach will help ensure that consumers served by noncompetitive systems will be offered regulated services at reasonable rates.[29] In addition, when the rates for regulated services fall as a result of the application of the competitive differential, the quantities of these services demanded by consumers should rise as new subscribers are added, fewer subscribers disconnect, and individual subscribers purchase additional programming services. These increases in demand will help offset the effect of the required rate reductions on operator revenues.[30] The increased sales of existing regulated services should also be supplemented by demand for new services, both regulated and unregulated.

21. In particular, reducing regulated service rates will increase operators' motivation to invest in unregulated services that will apply advanced technology and to introduce entirely new services, such as broadband interactive services. Cable systems that now offer regulated service without competition will have an incentive to upgrade their systems with new capabilities and will have an incentive to introduce enhanced functions, such as interactivity, that are not subject to rate regulation. These developments will benefit operators by increasing revenues and benefit subscribers by increasing the affordability and availability of unregulated service offerings.

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[29] It should be emphasized that not all consumers are assured savings from rate regulation. Under the Act, rate regulation occurs only when a local franchising authority is certified by the Commission to regulate basic service rates and when a subscriber complains about upper tier rates to the Commission. See Communications Act, Sections 623(a)(3), (c)(1)(B); 47 U.S.C. Section 543(a)(3), (c)(1)(B). Although many operators have voluntarily restructured their offerings in an effort to comply with the Commission's rate standards, the reliability of those efforts can only be measured, and the ongoing benefits of rate regulation can only be assured, in those cable communities where regulation is actually triggered.

[30] The level of subscriber penetration was 61.5 percent in 1992, is estimated to have increased to 62.4 percent in 1993 and is forecast to increase to 63.3 percent in 1994. Department of Commerce, U.S. Industrial Outlook 1994, at 31-6.

22. Our "going-forward" mechanism and cost-of-service procedures also will facilitate the development of new regulated services. For instance, because we are adopting a "going-forward" methodology for increasing rates when new program services are added to regulated service tiers, operators may launch new program services as part of regulated service tiers. A key concern expressed by operators and programmers throughout this proceeding has been that the benchmark approach may not permit operators to respond to marketplace incentives to expand the services included in regulated program tiers. The "going-forward" methodology set forth in this Order provides such incentives for the benefit of operators, programmers, and subscribers alike.

23. Our approach to rate-setting preserves incentives to invest in new services without imposing the burdens of financing new, unregulated offerings on regulated service subscribers. There is no sound policy reason to permit regulated operators to charge rates for regulated services that are higher than reasonable levels in order to support investment in plant used principally to provide unregulated services. Indeed, it has long been the Commission's policy to protect regulated ratepayers from subsidizing unregulated offerings through supra-competitive regulated rates.[31] Rather, the risk of providing new, unregulated services has been placed, appropriately, on investors and shareholders. We see no reason to depart from that policy here.

24. We note that the regulatory system we have adopted for cable rate regulation on a going-forward basis is in essence a price cap scheme that is similar in many respects to the price cap regime we have adopted for the telephone industry. Rates set by applying the competitive differential are capped at that level, and cable operators may increase rates only to reflect inflation, increases in external costs such as franchise-related costs, and to reflect the costs of additional services. Our regulatory approach -- like telephone price caps -- directly regulates the prices charged to subscribers rather than indirectly regulating prices through an examination of underlying costs. Accordingly, we fully anticipate that the public will see similar benefits to those we have already witnessed from our

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[31] Our interim cost-of-service rules issued today will also help guard against this cross-subsidization. See Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215, FCC 94-39 (adopted Feb. 22, 1994). See also Joint Cost Order, CC Docket 86-111, 2 FCC Rcd 1298 (1987) (Report and Order), recon., 2 FCC Rcd 6283 (1987), modified on recon., 3 FCC Rcd 6701 (1988), aff'd sub nom., Southwestern Bell Co. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

telephone price cap regulations: lower prices for regulated services, service innovation, and increased operator efficiency, all of which contribute to industry growth and increased competition.[32] We also believe that, as the cable and telephone industries converge, it is important to treat them with as much regulatory parity as possible. Adoption of our revised approach for regulating cable rates thus is a significant step in the right direction.

25. The specific changes we are making on reconsideration are as follows: First, as noted above, we are strengthening our statistical and economic model for estimating the difference between the rates charged by systems facing effective competition and those that do not. In our April 1993 Rate Order we estimated the competitive differential to be approximately ten percent.[33] Numerous petitioners have challenged our methodology for deriving that figure on a variety of grounds. In response to those challenges, we have undertaken a broad review of our methodology and have refined it.

26. Our new methodology was developed in part by addressing the statistical issues identified by commenters and our staff, such as using a corrected data set and revising the treatment of equipment and installation revenues.[34] The principal difference in calculating the new competitive differential, however, is a revised economic analysis that reflects more accurate assessments of the different types of systems that the statute defines as subject to effective competition. As noted above, Congress listed three types of systems as being subject to "effective competition" -- low penetration systems, overbuilds, and municipals.[35] As also noted above, Congress directed the Commission, when determining whether rates are reasonable, to be guided by the goal of protecting subscribers from rates higher than those charged by those three categories of systems.

27. Statistical analysis reveals that each of the three

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[32] See Price Cap Performance Review for AT&T, CC Docket No. 92-134, 8 FCC Rcd 6968 (1993) ("Report and Order"); see also Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, FCC 94-10 (released Feb. 16, 1994) ("Notice of Proposed Rulemaking").

[33] Rate Order at para. 180.

[34] See Technical Appendix for an explanation of these changes.

[35] Communications Act, Section 623(l)(1), 47 U.S.C. Section 543(l)(1).

types of systems has its own competitive differential. Because the three classes of systems differ from each other, we conclude that it is more appropriate to consider the competitive differential for each type of system individually than it is to average the data relating to all three system types.[36] We also conclude that we are not required by the statute to compute the competitive differential simply by averaging, without evaluation, the rates charged by the three different types of systems. Rather, we interpret the Act as requiring us to "take into account" or "consider" the rates charged by each type in determining reasonable rates.[37]

28. In selecting the best method of setting reasonable rates on reconsideration, we conducted an economic analysis that considered the competitive differential for each of the three categories of systems that Congress defined as facing "effective competition," as well as the other statutory factors, the facts of record, and the comments of interested parties. This analysis reveals that the rates of low penetration systems are not statistically different as a group from the rates of systems subject to rate regulation. We are not persuaded, however, that low penetration systems and noncompetitive systems are charging reasonable rates. Rather, we conclude that there may be a variety of reasons other than competitive pressures, as measured by the statutory definition, that have led to low penetration rates. While Congress has concluded that low penetration systems should be exempt from rate regulation, it does not follow that the rates they charge provide the best basis for determining the competitive differential that should apply to noncompetitive systems.

29. We further believe that systems in the overbuild sample provide the most informative data with regard to estimating reasonable rates. Our best estimate of the difference between the rates charged by overbuilds and noncompetitive systems is 16 percent. That figure takes into account the fact that cable operators generally do not compete head-to-head in the entire franchise area they serve. Specifically, our data show, as we expected, that rates decrease as the extent of competition increases. We thus have corrected for the lack of full competition throughout an entire franchise area when computing

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[36] Specifically, we applied an F test, a standard test of the equivalence of several parameters, to the variables representing the three competitive samples. They proved to be statistically significantly different at much better than the 1 percent confidence level.

[37] Communications Act, Sections 623(b)(2)(C)(i), (c)(2)(B); 47 U.S.C. Sections 543(b)(2)(C)(i), (c)(2)(B).

the competitive differential for overbuild systems.

30. In focusing on the overbuild sample, it is also appropriate to adjust the 16 percent figure to take into account the fact that cable operators serving the same area may adopt parallel or coordinated pricing practices. That is, they may recognize, over time, that it makes more economic sense not to compete vigorously, but to coordinate their prices tacitly.[38] Economic theory states that firms operating in oligopoly structures may be expected to behave in that manner.[39] Thus, prices observed in an overbuild situation may well be above the purely competitive level. We therefore conclude that the observed 16 percent average competitive differential for overbuild systems underestimates the true competitive differential. Our data indicate that the rates charged by overbuild systems are lowest at the outset of competition and then rise over time. This is consistent with parallel pricing behavior and strengthens our conclusion that the best estimate of the overall competitive differential is greater than the overbuild differential of 16 percent.[40]

31. The largest differential, 37 percent, arises in the comparison of the rates charged by noncompetitive systems with those charged by municipal systems and the privately owned systems that compete with them. Arguably, this differential may be the most accurate measure of the competitive differential because government-operated entities may be presumed to charge reasonable rates and have no incentive to engage in the parallel or tacitly coordinated pricing practices discussed in the context of overbuild systems. It has been suggested, however, that municipal systems may not be earning a profit. The record evidence on this point is inconclusive. Because of these concerns, we separately examined the rates charged by the privately-owned cable systems in our sample of "municipal" systems. The competitive differential is equally large for these private systems, which suggests that the rates charged by the public and private systems in our municipal sample are reasonable. However, in view of the small number of systems in the municipal category (only eleven) and our concern that they

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[38] Economic theory refers to this behavior as "conscious parallelism." F.M. Scherer and D. Ross, Industrial Market Structure and Economic Performance (3d.ed. 1990) at 339-347.

[39] See generally, id. at 199-226.

[40] The 16 percent competitive differential calculated for overbuild systems reflects an average that is weighted toward systems that have been in competition for three or more years because there are more of these older systems than newer ones.

may not be representative, we believe that we should not rely as heavily on municipals as we otherwise might in estimating the competitive differential.

32. After reviewing the data from all three types of non-regulated systems, but giving the most emphasis to the data relating to overbuilds, we have selected 17 percent as the revised competitive differential. In selecting that figure, we were guided by the 16 percent figure estimated from our data on overbuilds that measures full head-to-head competition. We moved upward from 16 percent to reflect our conclusion that cable operators in an overbuild situation are likely over time to develop a tacit understanding of rate levels that may limit the intensity of rate competition. However, we did not depart upward as far as we might have, despite the evidence relating to municipal systems, on account of concerns about the interpretation of the data in our municipal subsample and on account of our consideration of low penetration systems. Furthermore, we were guided by our belief that consumer welfare is best served by financially sound cable operators.

33. It should be emphasized that this 17 percent rate reduction is not in addition to the prior ten percent rate reduction that some operators already have applied. Rather, those operators that have already established rates based on a ten percent competitive differential will only be required to adjust rates by approximately seven percent.[41]

34. Second, with the limited exception provided by the transition mechanism, we will require all noncompetitive systems that do not invoke the cost-of-service option to reduce their rates by the revised competitive differential. Cable systems that do not do so will be subject to refunds ordered by the franchising authority or the Commission once they become regulated.[42] In the April 1993 Rate Order, we concluded that

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[41] The additional seven percent reduction is approximate rather than exact because we have made other changes in the benchmark calculation. As explained in more detail, infra, we have expanded the number of variables used to determine what rate a similar system facing effective competition would charge. The additional variables make the benchmark calculation more accurate.

[42] We will not, however, impose refund liability on systems that implement the rate reduction provisions of this Order by July 15, 1994 for the period between May 15 and July 15, 1994, as long as the system meets certain conditions to maintain the status quo during that period. We discuss these conditions at note 141, infra.

operators whose rates on the date of regulation are "below benchmark" should not be required to reduce those rates, despite the fact that they face no effective competition. As noted above, however, we have concluded upon further reflection that behavior reflective of market power may exist generally within the noncompetitive sector of the cable industry. For this reason, we have concluded that it is preferable to apply a single percentage adjustment to all noncompetitive systems.

35. At the same time, our lack of cost-price data regarding small operators and relatively low-priced systems persuades us that we should not apply the full competitive differential to these categories as of the effective date of our new rules. On the basis of our refined statistical analysis, we therefore continue to believe that our primary approach for regulating cable rates at this time should incorporate a benchmark mechanism. Accordingly, cable operators whose September 30, 1992 rates (when adjusted by the full 17 percent competitive differential and permitted increases) are above the revised benchmark must apply the full differential or invoke cost-of-service proceedings. Cable operators whose March 31, 1994 rates are at or below the new benchmark do not have to reduce their rates at this time, pending the Commission's collection and analysis of information about such operators' prices and costs. And, cable operators whose March 31, 1994 rates are above the new benchmark, but whose rates would be at or below the new benchmark if the revised competitive differential were applied in full to their September 30, 1992 rates, must bring their rates down to the new benchmark immediately, but do not have to apply the full competitive differential pending our analysis of prices and costs. At the conclusion of our cost study, cable operators that do not apply the full revised competitive differential immediately will be required to do so unless our analysis reveals that application of the 17 percent differential to those systems would be inappropriate.

36. We are also not requiring small operators, defined for these purposes as operators serving a total subscriber base of 15,000 or fewer subscribers, and not affiliated with or controlled by larger operators, to apply the revised competitive differential immediately. While some commenters have submitted evidence to suggest that some smaller systems may face higher costs compared to larger systems, the absence of industry-wide cost data leaves us unable to conclude that all small systems face systematically higher costs.[43] Moreover, while publicly

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[43] See e.g., Coalition of Small System Operators, Supplemental Information re: Programming Costs for Large Cable Operators versus Small Operators; Small Cable Business Association, Supplemental Comments in Further Support of Interim

available financial data indicate that large operators are better able to absorb further rate reductions, the financial data we have concerning small operators is not as extensive or as reliable as the data we have concerning large operators. Accordingly, we are not requiring small operators to apply the competitive differential immediately pending our collection and analysis of information about costs and prices. As with other operators subject to transition treatment, however, small operators will be required to apply the full revised competitive differential unless our analysis of costs and prices demonstrates that the revised competitive differential should not be applied to them.[44]

37. Third, we are providing new guidelines with respect to the regulatory treatment of "a la carte" packages. Under the 1992 Cable Act, the rates for channels offered on a stand-alone basis ("a la carte" channels) are not regulated.[45] In our April 1993 Rate Order, we held that operators may offer subscribers discounted packages of "a la carte" channels without subjecting the package price to rate regulation as long as the channels continued to be offered on a stand-alone basis.[46] We adopted this approach in an effort to encourage increased programming choices

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Benchmark Adjustments for Low Density and Smaller Cable Operators at 5-10.

[44] Cable systems that are not required to apply the full competitive differential immediately -- either because they are owned by a small operator or because they charge relatively low prices -- may increase their rates on account of increases in external costs and improved service offerings, but may not increase rates on account of inflation, except to the extent inflation exceeds the portion of the competitive differential that the operator was not required to implement because of its eligibility for transition relief.

[45] Communications Act, Section 623(1)(2), 47 U.S.C. Section 543(1)(2).

[46] Rate Order at paras. 326-329. The Commission imposed two conditions for exempting from regulation packages of "a la carte" channels. Under the first condition, the price for the combined package must not exceed the sum of the individual charges for each component service. The second condition requires cable operators to continue to provide the component parts of the package to subscribers separately in addition to the collective offering. We have stated that the second condition would be met only when the per-channel offering provides subscribers with a realistic service choice. Id. at paras. 326-329 & n.808.

and discounts for consumers.[47] We did not anticipate that many operators would use this technique to take channels out of regulated service tiers and offer them on an unregulated basis.[48]

38. A September 1993 Commission survey (hereinafter "Competitive Survey") reveals, however, that many operators have taken that course. Specifically, of the 25 largest multiple system operators included in the Competitive Survey, 12 removed channels previously offered on regulated program service tiers and began offering them in "a la carte" packages. Moreover, the terms and conditions of some "a la carte" packages offered following rate regulation have raised issues as to whether the option of purchasing the channels on a stand-alone basis is real or illusory.[49]

39. Accordingly, in an effort to ensure that "a la carte" offerings provide subscribers with realistic service choices and to protect against prohibited evasions of rate regulation, we are announcing interpretive guidelines for determining whether the rates for an operator's collective offering of "a la carte" channels should be regulated or nonregulated. Using these guidelines, local authorities may make initial determinations as to whether a collective offering of "a la carte" channels should be considered a regulated tier. Cable operators or consumers may then make an interlocutory appeal to the Commission of the local authority's decision. Local authorities may also request the Commission to make the initial "a la carte" decision by means of a petition for declaratory ruling.[50]

40. Fourth, we adopt a "going-forward" methodology in this Order to adjust rates when operators add or delete channels from a regulated service tier after they have become subject to regulation. Under this methodology, the efficiencies and economies of scale that arise as operators add channels to their systems are passed on to subscribers. At the same time,

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[47] See id. at para. 327.

[48] See id. at para. 328, n.808.

[49] See FCC News, "FCC Issues Letters of Inquiry Concerning Cable Rate Restructuring" (released Nov. 17, 1993); FCC News, "FCC sends 35 Letters of Inquiry Concerning Cable Rate Complaints" (released Dec. 13, 1993); "FCC Sends 11 Letters of Inquiry Concerning Cable Rate Complaints" (released Feb. 23, 1994).

[50] As discussed at note 263, infra, packages of "a la carte" channels offered prior to April 1, 1993 may continue to be offered on an unregulated basis.

operators may recover the full amount of programming expenses associated with added channels, plus a markup on new programming expenses of 7.5 percent. This methodology provides a relatively simple way for operators to adjust rates. It also provides appropriate incentives for operators to provide additional, high quality programming. The going-forward methodology accordingly will promote our goals of assuring reasonable rates while encouraging the continued growth of the cable industry.[51]

41. Fifth, we revise our rules to provide greater administrative relief to small systems, defined in the Act as systems with 1,000 or fewer subscribers.[52] In particular, until we develop average cost schedules for equipment, we relieve small systems owned by small operators[53] of the requirement that they establish unbundled equipment rates based on actual cost because that requirement appears to have imposed substantial burdens on small operators. Instead, eligible systems, if they so choose, may make rate reductions by reducing each regulated billed item by 14 percent (which equals the 17 percent competitive differential reduced by approximately three percent inflation that occurred between October 1992 and September 1993).[54] These systems are not required to file Form 1200. In addition, we will permit all operators of small systems[55] that do file FCC Form 1200 to aggregate their equipment costs for their small systems when establishing equipment rates. Finally, we are terminating our stay of rate regulation for small systems. We will entertain requests from small systems to extend the period of time in which they must comply with our rate regulations where they can demonstrate that specified hardship conditions exist.

42. For all cable systems subject to regulation, the rates

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[51] In our Cost Proceeding, we have established procedures for streamlined cost-of-service showings for upgrades and an incentive upgrade plan. We believe that these procedures also will facilitate growth of program service offerings.

[52] Communications Act, Section 623(i), 47 U.S.C. Section 543(i).

[53] For these purposes, a "small operator" is one that has 250,000 or fewer total subscribers, owns only systems with less than 10,000 subscribers each, and has an average system size of 1,000 or fewer subscribers. See discussion at para. 216, infra.

[54] Eligible small systems need not implement these streamlined rate reductions but may instead choose to establish rates under our revised benchmark approach.

[55] See infra paras. 218-221.

permitted between September 1, 1993 and May 15, 1994 (the effective date of these new rules), and refund liability with respect to such rates, will be determined by our initial regulations adopted on April 1, 1993. The lawfulness of rates in effect on or after May 15, 1994, and refund liability with respect to such rates, will be determined in accordance with the revised rules adopted in this Order.

B. Regulation Governing Rates of Basic and Cable Programming Service Tiers

1. Background

43. After Congress deregulated most cable rates in 1984[56], the rates charged by many cable systems rose significantly. For example, the monthly rate for the most popular program tier of cable service rose by an average of 60.8 percent from November 30, 1986, to April 1, 1991.[57] Monthly rates for the lowest priced basic service tier increased by 40 percent or more for 28 percent of subscribers.[58] Although the number of channels on the average cable system also increased during the same time period, many consumers felt that the increases in their cable rates were nonetheless unreasonable.

44. Partly in response to concerns about rising cable rates, a number of economists have studied the cable industry to determine whether cable operators have significant market power. Many of these empirical studies were designed to predict the demand for cable services; others attempted to estimate the supply function for cable systems.[59] A number of the studies were conducted when cable systems had far fewer channels than they typically do today and many were based on very limited data samples. Nonetheless, while the purposes and specific results of the studies vary depending on the particular variable estimated or projected, the time period evaluated, and the variables and forms of equations used, one result is clear: the vast majority

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[56] Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (1984).

[57] See supra note 10.

[58] Cable Act of 1992, Section 2(a)(1).

[59] The demand function is the relationship between quantity of cable services consumed and price, with quantity consumed decreasing as price increases. The supply function is the relationship between quantity of cable services produced by the cable operator and price, with quantity produced increasing as price increases.

of the studies found that cable systems have some market or monopoly power and that these systems earn, or would earn in the future, monopoly profits.[60]

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[60] See for example: Roger G. Noll, Merton J. Peck and John J. McGowan, Economic Aspects of Television Regulation (1973); G. Kent Webb, The Economics of Cable Television (1983); Eli M. Noam "Local Distribution Monopolies in Cable Television and Telephone Service: The Scope for Competition," in Telecommunications Regulation Today and Tomorrow edited by Eli M. Noam (1983), 351-416; Bruce M. Owen and Peter R. Greenhalgh, "Competitive Policy Considerations in Cable Television Franchising," reprinted in U.S. House of Representatives, Committee on Energy and Commerce, Subcommittee on Telecommunications, Consumer Protection and Finance, Options for Cable Legislation, Hearings, 98th Cong., 1st Sess., (1983); 69-117; Eli M. Noam, "Competitive Entry in Local Cable Transmission," chapter 17 in Policy Research in Telecommunications edited by Vincent Mosco (1984), 190-200; Thomas W. Hazlett, "Competition vs. Franchise Monopoly in Cable Television," 4 Contemporary Policy Issues (1986), 80-97; "Opening The Broadband Gateway: The Need for Telephone Company Entry into the Video Services Marketplace," by Shooshan and Jackson, Inc., papers prepared for the United States Telephone Association (October, 1987); "Measuring Cable's Market Power: Recent Developments," Shooshan and Jackson, Inc., paper prepared for the United States Telephone Association, (December, 1988); Mark A. Zupin, "The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence,"32 Journal of Law and Economics (1989), 401-456; Mark A. Zupin, "Cable Franchise Renewals: Do Incumbent Firms Behave Opportunistically?" 20 Rand Journal of Economics (1989), 473-482; A. B. Jaffe and D. M. Kanter, "Market Power of Local Cable Television Franchises: Evidence from the Effects of Deregulation," 21 Rand Journal of Economics (1990), 226-234; Robin A. Praeger, ""Firm Behavior in Franchise Monopoly Markets," 21 Rand Journal of Economics (1990), 211-225; Paul W. MacAvoy, "Tobin's q and the Cable Industry's Market Power," Appendix 5 to the United States Telephone Association Comments to the FCC in CC Docket 89-600 (1990); Thomas W. Hazlett, "Duopolistic Competition in Cable Television: Implications for Public Policy," 7 Yale Journal on Regulation (1990), 65-139; Stanford L. Levin and John B. Meisel, "Cable Television and Competition: Theory, Evidence and Policy," Telecommunications Policy (1991), 519-527; Robert. N. Rubinovitz, "Market Power and Price Increases for Basic Cable Service Since Deregulation," 24 Rand Journal of Economics (1993), 1-18; Thomas W. Hazlett, "Cable TV Reregulation: The Episodes You Didn't See on C-Span," Regulation (1993), 45-52. These studies are consistent with, and support, Congress' finding that operators not subject to effective competition generally exercise undue market power.

45. The conclusion that most cable systems exercise market power was embraced by Congress when it passed the Cable Television Consumer Protection and Competition Act of 1992. Specifically, Congress found that (1) "most subscribers have no opportunity to select between competing cable systems" and (2) "without the presence of another multichannel video programming distributor, a cable system faces no local competition."[61] The result, Congress concluded, "is undue market power for the cable operator as compared to that of consumers and video programmers."[62]

46. Congress accordingly charged the Commission with creating a regulatory scheme that will protect consumers from unreasonable cable rates until competition to or within cable services emerges and ensures that rates are set at competitive levels. Section 3 of the 1992 Cable Act provides that cable systems that face no effective competition, as that term is defined in the statute,[63] will be subject to rate regulation by their local franchising authorities and/or this agency.[64] Section 3 further instructs the Commission to ensure that the rates for basic service are reasonable and that in response to complaints, the rates for regulated upper tier cable programming services are not unreasonable.[65] And, it requires that rates for regulated cable equipment used to receive the basic tier be based on actual cost.[66] The Commission's regulations regarding basic tier rates are to "be designed to achieve the goal of protecting subscribers of any cable system that is not subject to effective competition from rates for the basic service tier that exceed the rates that would be charged for the basic service tier if such system were subject to effective competition."[67]

47. In the Notice of Proposed Rulemaking ("Notice") in this proceeding, we tentatively identified a benchmark approach as the best means of implementing the rate regulation provisions of the

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[61] Cable Act of 1992, Section 2(a)(2).

[62] Id.

[63] Id. at Section 623(l)(1), 47 U.S.C. Section 543(l)(1).

[64] Communications Act, Section 623(a)(2), 47 U.S.C. Section 543(a)(2).

[65] Id. at Section 623(b)(1), (c)(1), 47 U.S.C. Section 543(b)(1),(c)(1).

[66] Id. at Section 623(b)(3), 47 U.S.C. Section 543(b)(3).

[67] Id. at Section 623(b)(1), 47 U.S.C. Section 543(b)(1).